



King County

July 26, 2004

**Honorable County Executive, Members of the
Metropolitan King County Council, and King
County Residents**

We are pleased to transmit to you the Comprehensive Annual Financial Report (CAFR) of King County, Washington, for the fiscal year ended December 31, 2003. This is the second year for several new reporting standards that have significantly impacted report presentation. The new governmental financial reporting model provides a clear picture of the County as a single, unified entity, while continuing to provide traditional fund-based financial statements. Each perspective (government-wide and major fund) allows the reader to address relevant questions, provides a basis for comparison (year to year or government to government), and enhances the County's accountability.

The report is presented in three sections: Introductory, Financial, and Statistical. The Introductory Section includes this letter of transmittal. The Financial Section, beginning with the independent auditor's report, contains management's discussion and analysis (MD&A), government-wide financial statements, fund financial statements, notes to the financial statements, required supplementary information, combining financial statements, and schedules. This letter of transmittal is designed to complement the MD&A, which presents a narrative introduction, overview, and analysis of the financial statements. The Statistical Section includes selected financial, economic, and demographic data.

The CAFR consists of management's representations concerning the finances of the County. Consequently, management assumes full responsibility for the completeness and reliability of all information presented in this report. To provide a reasonable basis for making these representations, management has established a comprehensive internal control framework designed both to protect the government's assets from loss, theft, or misuse, and to compile sufficient reliable information for the preparation of the County's financial statements in conformity with Generally Accepted Accounting Principles (GAAP). Because the cost of internal controls should not outweigh their benefits, the County's comprehensive framework of internal controls has been designed to provide reasonable rather than absolute assurance that the financial statements will be free from material misstatement. As management, we assert that, to the best of our knowledge and belief, this financial report is complete and reliable in all material respects.

The County's financial statements have been audited by the Washington State Auditor's Office. The goal of the independent audit was to provide reasonable assurance that the financial statements of the County for the fiscal year ended December 31, 2003, are free of material misstatement. The independent audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial statement presentation. The auditor concluded, based upon the audit, that there was a reasonable basis for rendering an unqualified opinion that the County's financial statements for the fiscal year ended December 31, 2003, are fairly presented in conformity with GAAP. The auditor's report is presented as the first component of the financial section of this report.

The independent audit of the financial statements of the County was part of a broader, federally mandated "Single Audit" designed to meet the special needs of federal grantor agencies. The standards governing Single Audit engagements require the independent auditor to report not only on the fair presentation of the financial statements, but also on the audited government's internal controls and compliance with legal requirements, with special emphasis on internal controls and legal requirements involving the administration of federal awards. These reports are available in the County's separately issued Single Audit Report.

GAAP require that management provide a narrative introduction, overview, and analysis to accompany the basic financial statements in the form of management's discussion and analysis (MD&A). This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it. The County's MD&A can be found immediately following the report of the independent auditors.

Profile of the County

The County ranks number one in population in the State of Washington and is the financial, economic, and industrial center of the Pacific Northwest Region. Located between the sparkling blue waters of Puget Sound and the snowcapped Cascade Mountains, the County consists of 2,134 square miles, ranking 11th in geographical size among Washington State's 39 counties. As of December 31, 2003, the County contained 39 incorporated cities, which accounted for approximately 80 percent of its population.

King County operates under a Home Rule Charter adopted by a vote of the citizens of King County in 1968 and is organized under the Executive-Council form of county government. The Metropolitan King County Council is the policy-determining legislative body of the County. The Council's 13 members are elected by district to four-year staggered terms and serve on a full-time basis. The County Council sets tax levies, makes appropriations, and adopts and approves the annual operating and capital budgets for the County. Other elected county officials include the County Executive, Prosecuting Attorney, Sheriff, Assessor, and Superior and District Court Judges. All are partisan positions, elected at large to four-year terms, except for the Sheriff and Judges, which are non-partisan positions.

The County Executive serves as the chief executive officer of the County. The County Executive presents to the County Council annual statements of the County's financial and governmental

affairs, the proposed budget, and capital improvement plans. The County Executive signs, or causes to be signed on behalf of the County, all deeds, contracts, and other instruments, and appoints the director of each executive department.

King County provides some services on a countywide basis and other services only to unincorporated areas. Within appropriate jurisdictions, the County provides public transportation, road construction and maintenance, water quality, flood control, parks and recreation facilities, court services, law enforcement, agricultural services, inquests, tax assessments and collections, fire inspections, planning, zoning, animal control, criminal detention, rehabilitative services, public healthcare, emergency medical services, election administration, and the processing and disposal of solid waste. In addition, the County has contracts with some cities to provide services to incorporated areas within the County.

The reporting entity "King County" includes four component units: (1) the Harborview Medical Center (HMC); (2) the Washington State Major League Baseball Stadium (WSMLB) Public Facilities District (PFD); (3) the Cultural Development Authority of King County (CDA); and (4) the Flood Control Zone Districts. The Harborview Medical Center, with a history dating back to 1877, is a comprehensive 413-bed healthcare facility operated since 1967 by the University of Washington under a management contract. The general conditions of the management contract specify that King County retains title to all real and personal property acquired with HMC capital or operating funds. The PFD is responsible for overseeing the maintenance and operation of Safeco Field, the Seattle Mariners' baseball stadium. The CDA was created in 2003 to support the arts, heritage, historic preservation, and public art throughout the County. The Flood Control Zone Districts account for the undertaking, operation, or maintenance of flood control projects or storm water control projects that are of special benefit to specific areas of the County.

Most funds in this report pertain to the entity King County Government. Certain Agency Funds pertain to the County's custodianship of assets belonging to independent governments and special districts. Under state statute and the County's Home Rule Charter, the King County Executive is the *ex officio* treasurer of all special purpose districts in King County, but not of cities and towns or the Port of Seattle. As provided by County ordinance, the Director of the Finance and Business Operations Division is responsible for the duties of the comptroller and treasurer. Monies received from or for the special purpose districts are deposited in a central bank account. The Director of the Finance and Business Operations Division invests or disburses monies according to the instructions of the respective special purpose district's governing body or administrative officer.

Factors Affecting Financial Condition

The information presented in the financial statements is perhaps best understood when it is considered from the broader perspective of the specific environment within which the County operates.

Local economy. Economic conditions have a direct impact on the County's revenues and demand for County services. The County's revenue sources include taxes, charges for services, and intergovernmental revenues. The largest single source is taxes, which comprise

approximately one-third of total revenue, and consist primarily of taxes on real property. The property tax tends to be quite stable due to its relationship with assessed value. Other tax sources, such as the retail sales tax, are much more volatile and directly influenced by economic conditions in the region.

After entering a moderate recession in the second quarter of 2001, King County continued to experience poor economic conditions in 2003. Unemployment remained high at roughly 60,000 workers, or 6 percent, over the course of the year. The stock market rebounded, reversing, but not fully recovering, the sharp losses of the second and third quarters of 2002. Technology equities, with a few notable exceptions, remained stagnant, continuing a trend started with the end of the market bubble in 2000. As a consequence, personal income growth has largely stabilized with some growth attributable to stock option appreciation. The tight labor market for skilled technical workers of the late 1990s is now characterized by surplus, with a growing list of defunct internet-related firms. Moreover, changes in Microsoft employee compensation from stock options to outright accrual of shares will diminish the future potential for exceptional personal income growth while reducing volatility.

For a third consecutive year, General Fund retail sales tax revenue in the County declined, falling 0.7 percent in 2003. The 2001 decline of 3.5 percent was the first since institution of the local option sales tax in 1971, followed by a drop of 3.1 percent in 2002. All cases of negative growth prior to 2001 were caused by annexations and incorporations. Property value growth slowed significantly, with assessed valuation up just 4.8 percent in 2003, compared with 6.6 percent growth in 2002, 12 percent growth in 2001, and 13.3 percent growth in 2000. This decline is attributable to the ailing commercial market – residential values remained exceptionally robust throughout the year, buoyed in large measure by historically low interest rates. County property tax collections increased by 1.2 percent in 2003, compared with 6.2 percent in 2002, 4.5 percent growth in 2001, and 4.9 percent growth in 2000, the year before Initiative 747 took effect.

Economic outlook. For 2004 a strong national recovery is expected to fuel steady local improvement. Total regional employment in 2004 is forecast to keep pace with population growth for the first time in four years, while personal income growth should nearly double to 4.5 percent.

The County will continue to face numerous challenges including volatile energy prices and the need to raise sufficient revenues to pay for the operations of its utilities, transit system, and general government operations. Uncertainties related to the occupation of Iraq could result in further economic contraction, particularly in consumer spending.

Long-term financial planning. King County faces substantial structural imbalances in the General Fund stemming from Initiative 747's tight constraints on property tax revenue. With property tax growth capped at approximately 2.1 percent over the coming years (Initiative 747 caps property tax levies at 1 percent plus new construction), and the County's long-term cost structure, driven by labor costs and service utilization levels, growing by 5-6 percent, substantial shortfalls will continue for the foreseeable future.

To date, the County has aggressively managed the budget through sharp spending reductions to maintain both a balanced financial position and a steadfast commitment to the County's 6 percent undesignated reserve policy. The County plans to continue this strategy in the future, as well as the often painful process of reducing expenditures to match revenue levels while retaining prudent reserves. At the state level, the County also continues to pursue statutory enhancements to local government revenues to address the long-term structural imbalance.

Major Initiatives

Budget Advisory Task Force

A Budget Advisory Task Force (BATF) convened in 2003 to examine King County's General Fund programs, policies, processes, and budgets and make recommendations regarding policy and operational changes that may provide appropriate additional cost savings, as well as the need, if any, for additional revenues in support of General Fund programs. The group completed its work in June 2003 and made recommendations for the Executive's review and possible action. Members of the BATF included leading corporate executives and two former governors who also served as county executives.

The Task Force emphasized that the fundamental problem facing the County's General Fund is that expenditures are growing at 5-6 percent per year while revenues are growing at about 2 percent per year. As the Task Force Report stated, "...as currently structured and funded, King County's general government services are not sustainable." While the Task Force did not identify any single solution to correct this structural imbalance of the County's General Fund, it provided direction and recommendations aimed at reducing costs and making county government more efficient.

The Task Force recommended that King County undertake several initiatives aimed at reducing expenditures over the next few years and take steps to move out of urban local service delivery, consistent with County management's long-term regional land-use vision. These initiatives require investment today that will pay off in the future with reduced costs, improved efficiency, and increased productivity of King County employees.

Annexation of Urban Unincorporated King County

The Task Force stated that the effort to align local service responsibilities and revenues through an effort to accomplish annexation of the remaining urban unincorporated areas of King County "may be the single most important step the County can take to address its fiscal challenges."

The taxpayers of the region subsidize services provided to these urban unincorporated areas. The estimated 2004 General Fund subsidy for urban unincorporated King County is estimated at more than \$37 million. While there may be disagreement with the calculation of which revenues are regional and which are local, it is evident that the region's land-use plans call for this transfer of local service responsibility to cities and that King County's General Fund will be under far less pressure if such a transfer is accomplished and local service budgets are reduced accordingly. To support this effort, the 2004 Budget established a \$10 million

Annexation Incentive Reserve and earmarked other monies to provide both cities and the residents in these urban unincorporated areas the means to at least partially finance the transition to city rule. These monies are intended to facilitate annexation of the remaining urban unincorporated areas which include some 218,000 residents. This annexation strategy will take several years to accomplish. The County has initiated dialogue with residents of unincorporated areas and work has already begun with cities to refine the basis on which these annexation negotiations will occur.

Investments in Technology

The Task Force also identified the need for King County to make long overdue investments in technology, primarily management information systems that will move County government into the 21st century. Last spring a \$10 million Transition Fund was established for the purpose of supporting critical investments in technology. The technology Strategic Advisory Council and the Budget Advisory Task Force have both noted that King County government has lagged behind in making essential investments in technology that generate savings, avoid future costs, enhance productivity, and improve public access to County services. All of these are especially critical at a time when resources are limited.

Solid Waste

In 2003 a proposal was announced for the County's solid waste utility to begin paying rent for use of the Cedar Hills Landfill, an asset owned by the County's General Fund. The agreement provides for a twenty-five year revenue stream to the General Fund. This new revenue stream, in the form of a rental payment of \$7 million annually, increasing at 3 percent each year, is dedicated to the support of discretionary regional health and human services that would otherwise be eliminated due to ongoing budget cuts. These services include assistance to victims of domestic violence and sexual assault, services to the homeless on our streets, at-risk youth and their families, community clinics that provide healthcare to our most needy residents, and many other basic health and human services.

Cash Management Policies and Practices

The Revised Code of Washington (RCW) allows King County to invest its surplus funds in U.S. Treasury and Agency securities, certificates of deposit, commercial paper, bankers' acceptances, and repurchase agreements secured by eligible securities. With the exception of one fund, all County monies are invested in the County's Investment Pool.

County investment policies establish parameters for operation of the investment pool. King County minimizes credit and market risks while maintaining a competitive yield. During 2003 the County's pool realized an average yield of 2.9 percent, down from 3.8 percent in 2002. Interest earnings of County funds in 2003 were over \$41 million, including over \$10.9 million for the General Fund. Ninety-seven percent of the deposits and investments held by the County as of December 31, 2003, are classified in the category of lowest credit risk in accordance with criteria established by the Governmental Accounting Standards Board.

Risk Management

As a municipal organization, the County has a wide range of loss exposures. The County uses three internal service funds to account for and finance property/casualty, workers' compensation, and employee medical and dental benefits self-insurance programs. Note 10 to the financial statements discloses the specific programs and claims liability changes during 2003 for each insurance program.

Pension Benefits

Qualifying County employees participate in the Public Employees' Retirement System (PERS), the Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF), or the Seattle City Employees' Retirement System (SCERS). PERS and LEOFF are statewide local government retirement systems administered by the State of Washington's Department of Retirement Systems under cost-sharing, multiple-employer defined benefit and defined contribution public employee retirement systems. Note 8 to the financial statements presents plan descriptions and information on funding policies.

Awards and Acknowledgements

The Government Finance Officers Association (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the County for its Comprehensive Annual Financial Report (CAFR) for the fiscal year ended December 31, 2002. This was the 22nd consecutive year that the County has received this prestigious award. In order to be awarded a Certificate of Achievement, the government must publish an easily readable and efficiently organized CAFR. This report satisfied both GAAP and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe that our current CAFR continues to meet the Certificate of Achievement Program's requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

The preparation of this report would not have been possible without the efficient and dedicated services of the Financial Accounting staff of the Finance and Business Operations Division. We would like to express our appreciation to all members of the division who assisted and contributed to the preparation of this report. Credit also must be given to the Executive and County Council for their support for maintaining the highest standards of professionalism in the management of the County's finances.

Respectfully submitted,



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Connie L. Griffith
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